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In the Matter of

Implementation of Section 273
of the Communications Act of 1934,
as amended by the
Telecommunications Act of 1996

CC Docket No. 96-234

**REPLY COMMENTS
OF THE
COMPETITION POLICY INSTITUTE**

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INTRODUCTION

The Competition Policy Institute (CPI)¹ offers these reply comments in response to the Federal Communications Commission's (FCC) Notice of Proposed Rulemaking (Notice)² in the above-captioned proceeding.

CPI supports the continued growth of a competitive equipment manufacturing industry. For this reason, CPI supports the entry of the Regional Bell Operating Companies (RBOCs) into the manufacturing market after meeting certain preconditions and under safeguards to protect against the possibility of anticompetitive conduct. The RBOCs have enormous resources and experience in communications technology. The FCC should recognize that they have the potential to bring a substantial amount of innovation to the manufacturing marketplace. At the same time, the RBOCs also maintain a virtual monopoly over local telephone service and purchase a large percentage of all equipment sold in this country, which may allow them to gain an unfair competitive advantage in the equipment manufacturing marketplace.

In developing the rules in this proceeding, the FCC must take care to balance the need to take advantage of the RBOCs' abilities while protecting against anti-competitive conduct. Once the RBOCs face competition for local telephone service,

¹The Competition Policy Institute (CPI) is an independent, non-profit organization that promotes state and federal policies to bring competition to telecommunications and energy markets in ways that benefit consumers.

²Notice of Proposed Rulemaking, In the Matter of Implementation of Section 271 of the Communications Act of 1934, as amended by the Telecommunications Act of 1996, FCC 96-472, 62 Fed. Reg. 3638 (January 24, 1997).

their incentives will shift from favoring their own products toward favoring the products that provide the highest quality of service at the least cost. In other words, the more competition exists for local telephone service, the fewer rules are necessary to protect against anticompetitive conduct.

For this reason, CPI urges the FCC to maintain its commitment to local telephone competition as the most effective means of preventing anticompetitive conduct by the RBOCs, reducing regulation, and bringing the benefits of competition to all consumers of telephone services and equipment.

A. Timing of the RBOCs' Entry into Manufacturing

CPI agrees with the tentative conclusion in the Notice and virtually every commenter in this proceeding that Section 273(a) allows each RBOC into the manufacturing market after receiving interLATA approval in one of their in-region States. This precondition was intended, in part, to give the RBOCs an additional incentive to implement the "competitive checklist" and to open their local telephone markets to competition.

While there is relative agreement among the commenters concerning when a Bell Operating Company (BOC) may manufacture, there is substantial disagreement concerning when an affiliate of a BOC may manufacture.³ Section 273(a) states that "A Bell operating company may manufacture . . . if the Commission authorizes that BOC or any BOC affiliate to provide interLATA services under section 271(d)." Four

³The term "Bell Operating Company" is defined to exclude any affiliates of such companies. See, section 3(4) of the Act, 47 U.S.C. §153(4).

RBOCs maintain that, since the language of section 273(a) only delays entry of a BOC into the manufacturing market, the statutory language allows an affiliate of a BOC to manufacture today.⁴ In contrast, the Notice and the other commenters do not draw a distinction between a BOC and its affiliate and appear to suggest that the language of section 273(a) precludes both a BOC and any affiliate of a BOC from manufacturing until interLATA authority is received.⁵

The four RBOCs' interpretation that section 273(a) does not apply to BOC affiliates leads to several unintended and illogical conclusions. As mentioned, under the four RBOCs' interpretation, an affiliate of a BOC could manufacture today, while the BOC itself may only manufacture after it or one of its affiliates receives interLATA authority. Yet section 272 states that a BOC may only conduct manufacturing through a separate affiliate (for the first three years and perhaps longer if extended by the FCC under section 272(j)). Since section 272 precludes a BOC from manufacturing even after it receives interLATA authority, the interLATA precondition is meaningless (for the time period that the separate subsidiary is required).

In other words, the four RBOCs' interpretation leads to the following result: If a BOC does not comply with the "checklist" and the other interLATA preconditions, it may engage in manufacturing through an affiliate; if it does comply with the

⁴See, Bell Atlantic/NYNEX Comments, p. 2.; Southwestern Bell Corporation Comments, pp. 3-4; Ameritech Comments, p.4.

⁵See, Notice, para. 8; Comments of the Telecommunications Industry Association (TIA Comments), pp. 6-7.

"checklist" and all the other interLATA preconditions, it still must manufacture using an affiliate because of the requirement of section 272. Under this approach, satisfying the competitive checklist would be irrelevant to the BOCs' ability to manufacture. CPI submits this interpretation renders meaningless the language of section 273(a) and is directly contrary to the intention of Congress.

The narrow reading advised by the four RBOCs leads to a number of other problems. First, using this analysis, one could argue that there is no prohibition on the RBOCs' entry into manufacturing at all because section 273 does not preclude the RBOCs or the BOCs from engaging in manufacturing.⁶ Further, this reading also suggests that some RBOCs would have to manufacture through a separate affiliate, while other RBOCs would not.⁷

For instance, in contrast to section 271, nothing in section 273 prohibits any BOC or any affiliate of a BOC from engaging in manufacturing today. In other words, section 273(a) allows a BOC to manufacture after it receives interLATA authority, but nothing says a BOC cannot manufacture before receiving this authority. Again, this interpretation would allow even a BOC itself to manufacture today. This literal interpretation would render section 273(a) meaningless and is illogical. Congress could not have intended the RBOCs to engage in manufacturing immediately, especially when both the Senate and the House bills, passed by each body, delayed the RBOCs' entry into manufacturing until after they receive interLATA approval.

This confusion arises from the definition of a Bell Operating Company. Section 3(4) defines the term "Bell operating company" by listing the companies. The list includes Southwestern Bell Telephone Company and U S West Communications Company (two companies that are usually regarded as Regional BOCs), as well as other individual companies, such as Bell Telephone Company of Nevada and Illinois Bell Telephone Company, etc. (that are usually regarded as BOCs). Pacific Telesis and Ameritech are "affiliates" of Nevada Bell and Illinois Bell, respectively. As a result, the interpretation of the term "Bell operating company" suggested by the four RBOCs leads to the perverse result that USWest and SBC may only manufacture using an affiliate that is separate from USWest and SBC, whereas Pacific Telesis and Ameritech would be able to manufacture using an affiliate that is separate from the Nevada Bell or Illinois Bell but not separate from Pacific Telesis or Ameritech.

CPI submits that the only way to give consistent meaning to the statutory language is to read the term "Bell operating company" in section 273(a) to include the BOC and any affiliate of the BOC. It is difficult to believe that Congress could have intended the results discussed above without providing some amount of legislative history to explain its intention. Thus, the FCC should clarify that section 273(a) precludes manufacturing by a BOC and any affiliates of the BOC until it has obtained interLATA authority for one of its in-region States.

B. The Meaning of "Close Collaboration", "Research", and "Royalties."

Section 273(b) states that subsection (a) does not prohibit the BOCs from engaging in "close collaboration with any manufacturer", engaging in "research activities related to manufacturing", and entering into royalty agreements. The comments differ over whether these terms should be viewed as clarifications of the RBOCs' manufacturing authority or exceptions to the manufacturing definition.

Some of the RBOCs, for instance, argue that the provisions of subsection (b) are exceptions to the prohibition in subsection (a). In other words, they argue that the BOCs should be allowed to engage in close collaboration with manufacturers, conduct research, and enter royalty arrangements with other manufacturers even if these activities fall within the definition of "manufacturing." TIA, on the other hand, argues that the close collaboration provision allows the RBOCs to work closely with manufacturers to develop generic specifications and engage in other cooperative activities which (e.g., product testing) do not constitute

⁸See, e.g. BellSouth Comments, p. 4; SBC Comments, p.4.

"manufacturing," in order to ensure effective interconnection and interoperation of products designed for use in or connection to the BOC's network.⁹

TIA urges that such collaboration must be consistent with the structural separation and non-discrimination safeguards established in sections 272 and 273.

CPI supports those who argue that the terms "close collaboration", "research" and "royalty arrangements" clarify the scope of the manufacturing restriction and do not constitute exceptions to the definition of manufacturing. These activities are simply the flip side of the manufacturing "coin". A broad interpretation of these terms, as advocated by the RBOCs, would create such large exceptions to the manufacturing restrictions that they would swallow the rule. The interpretation offered by the RBOCs would make meaningless the separate affiliate requirements of section 272 and the interLATA preconditions of section 273(a).

CPI believes that the BOCs may engage in close collaboration, research and receive royalties as long as these activities do not constitute "manufacturing". The more manufacturing the RBOCs are permitted to conduct prior to receiving interLATA authority, the more likely they are to favor the manufacturers with whom they have a relationship, and the less incentive they will have to open their networks to competition.

C. Who May Engage in Close Collaboration?

Close collaboration between a BOC and an unaffiliated manufacturer allows

⁹TIA Comments, p. 13 (emphasis in original)

them to develop and design products to fit within the BOC's network and enhance services to consumers. Allowing such entities to engage in close collaboration does not harm competition in the manufacturing marketplace because the BOC does not have any incentive to favor one unaffiliated manufacturer over another, except to the extent the manufacturer produces a better product.

The FCC's Notice raises two issues, however, concerning close collaboration among BOCs and their affiliates. First is the issue of whether close collaboration between BOC affiliates violates the prohibition against joint manufacturing in section 273(a). In the Notice, the FCC tentatively concludes that section 273(b)(1) does not permit close collaboration between a BOC or an RBOC and the manufacturing affiliate of another unaffiliated BOC or RBOC; or between the manufacturing affiliates of two unaffiliated BOCs or RBOCs.¹⁰

Interestingly, no commenting party expressed the same concern as that raised by the FCC. Even TIA commented that a BOC may engage in "close collaboration" with any manufacturer, including the manufacturing affiliate of another BOC. TIA Comments, p. 14, note 32.

CPI shares the concern raised by the FCC that the BOCs should not be able to use the ability to engage in close collaboration as a means of evading the ban on joint manufacturing. For this reason, CPI suggests that the FCC should closely monitor the actions of the BOCs to ensure that they do not cross the line between collaboration

¹⁰Notice, para. 11.

and manufacturing. CPI does not, however, suggest an outright prohibition on close collaboration. As mentioned above, collaboration can lead to certain efficiencies and the development of new and innovative products that can benefit consumers.

A second concern, not raised in the Notice, arises if a BOC seeks to engage in close collaboration with its own manufacturing affiliate. In this case, the danger is that a BOC would use the close collaboration authority to evade the separation rules in section 272. Once again, the comments generally support allowing a BOC to collaborate with any manufacturer, including its manufacturing affiliate.

CPI agrees with the commenters that the BOCs should be allowed to engage in close collaboration with any manufacturer, including the BOC's manufacturing affiliate. Nevertheless, the FCC should remain vigilant to the possibility that such close collaboration could allow the BOC's manufacturing affiliate to gain an unfair competitive advantage over other manufacturers solely as a result of its financial relationship to the BOC. Once the BOC begins to manufacture using an affiliate, the BOC will have the incentive and ability, for instance, to provide network information first to its affiliate before releasing such information to other manufacturers. The "close collaboration" provision should not be read as an exception to the separate affiliate safeguards under section 272 of the Act.

D. The FCC Should Ensure that Royalty Arrangements Do Not Permit Discrimination.

CPI supports the FCC's statement in the Notice that the potential for discrimination is involved when the BOCs are permitted to enter royalty agreements

with unaffiliated manufacturers. As the FCC acknowledges, "allowing BOCs to collect royalties associated with licensing of intellectual property could potentially create some of the same anticompetitive incentives that would be created if the BOCs themselves engaged in manufacturing directly." (Notice, para 12)

CPI does not suggest that the BOCs be prohibited from entering into royalty arrangements. Rather, CPI suggests that the FCC should look carefully at any royalty agreements that a BOC might enter with a manufacturer to determine if the effect of the royalty agreement is to transfer control over the manufacturer to the BOC. The FCC should consider adopting rules concerning the types of royalty agreements that would constitute control and the types of agreements that would not. If a royalty agreement allows the RBOC to obtain de facto "control" over the manufacturer, the FCC should treat that manufacturer as if it were an affiliate and should subject the BOC and the manufacturer to the separation rules under section 272. These rules will be necessary to protect against the possibility that the BOC will favor the manufacturer because of its financial relationship with the manufacturer, not because the manufacturer offers the most competitive product.

E. The Network Disclosure Rules Should Apply Only to RBOCs that Are Engaged in Manufacturing or Have Royalty Arrangements with Unaffiliated Manufacturers.

Section 273(c) and (e) impose several requirements on the BOCs to disclose information about their network and to make procurement decisions on a nondiscriminatory basis. Several of the commenting parties disagree as to whether

these requirements should be imposed on all BOCs, or only those BOCs that are engaged in manufacturing.

For the most part, CPI thus agrees with the arguments of those commenters, including the RBOCs and Northern Telecom, who maintain that the provisions of sections 273(c) and (e) should only be applied to RBOCs who manufacture. Requiring RBOCs who are not involved in manufacturing to comply with these new rules would amount to unnecessary regulation. If the BOCs are not involved in manufacturing, they have little, if any, incentive to withhold network information from manufacturers or to favor one manufacturer over another. In fact, BOCs have incentives to make this information available to manufacturers in order to allow them to develop the best products for their networks. The BOCs have operated since divestiture without the requirements of sections 273(c) and (e) and the manufacturing market has shown a striking amount of competition.

The BOCs only develop incentives to withhold network information when they have a financial interest in a manufacturer. Only when a BOC begins to manufacture through a separate affiliate, or when it obtains a financial interest in a manufacturer, such as through a royalty arrangement, does it develop incentives to make information available about its network to certain manufacturers and not others. CPI believes that the provisions of sections 273(c) and (e) should apply when a BOC is engaged in manufacturing through an affiliate or has entered into a royalty arrangement with a

manufacturer.¹¹

Once a BOC enters the manufacturing market, however, the FCC must ensure that the BOC complies with rules to provide information about its network to all competing manufacturers. CPI is aware that the FCC currently requires the BOCs to make certain network information available to enhanced services providers. The FCC should review these rules, and amend them if necessary, to ensure that they provide the necessary information to manufacturers.

F. Bellcore Should Not Be Permitted to Manufacture Until After the FCC Determines in a Separate Proceeding that Bellcore Is Not an Affiliate of Two or More RBOCs.

Bellcore is precluded from engaging in manufacturing in two provisions of section 273. Subsection (a) forbids a BOC and any affiliate from manufacturing in conjunction with another BOC or its affiliates. Since Bellcore is currently jointly owned by several BOCs, this subsection prohibits Bellcore from manufacturing. Separately, subsection (d)(1)(B) explicitly prohibits Bellcore from "engag[ing] in manufacturing telecommunications equipment or customer premises equipment as long as it is an affiliate of more than 1 otherwise unaffiliated [BOC]". In both provisions, Bellcore is barred from manufacturing as long as it is owned by two or more BOCs or is an

¹¹CPI understands that the argument of TIA that the language of section 273(c) appears to apply to "each Bell operating company" without limitation. There at least two legal arguments that the FCC may use to avoid applying these regulations to non-manufacturing RBOCs. First, section 273(a) says that BOCs may manufacture subject to the requirements of this section. If the BOCs are not permitted to manufacture, arguably they are not subject to the requirements of this section, including subsections (c) and (e). Second, the FCC may interpret subsections (c) and (e) as applying to each BOC and then may forbear from applying the regulations to non-manufacturing BOCs under section 10 of the Communications Act.

~~affiliate of two or more BOCs.~~

Based on this statutory language, it is certainly premature for the FCC to conclude, as it suggests in the Notice, that the pending sale of Bellcore to Science Applications International Corporation (SAIC) would free Bellcore of the manufacturing restriction.¹² As Bellcore admits in its comments, "Bellcore's services have been valuable to its owners and clients in the past, . . . Bellcore currently plans to provide comparable services in the future."¹³ Even after the sale, Bellcore could continue its operations for the RBOCs on a long-term contract basis. Bellcore's comments in this proceeding fail to provide more information about the proposed sale and Bellcore's operations after the sale.

Given the historical relationship between the BOCs and Bellcore's management, employees, operations, testing and research capabilities, the FCC simply cannot make a blanket determination that Bellcore will be unaffiliated with the BOCs after the sale based solely on press accounts of the proposed transaction. At the very least, the FCC should examine the relationship between Bellcore and the BOCs after the proposed sale. In particular, the FCC should carefully examine whether long-term contracts between Bellcore and the RBOCs will effectively give the RBOCs "control" over Bellcore, even if they no longer have an equity interest.¹⁴

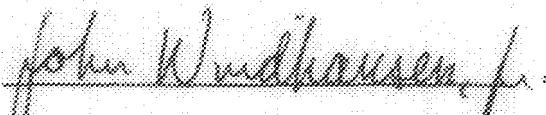
¹²See Notice, para. 38.

¹³Bellcore Comments, pp. 1-2.

¹⁴Even if the BOCs no longer hold an equity interest in Bellcore after its sale to SAIC, Bellcore may be an affiliate of the BOCs if they exercise "control" over Bellcore.

CPI thus urges the FCC to require Bellcore to file a separate petition, after the conclusion of its sale to SAIC, asking to be relieved of the manufacturing restriction. Since the legislative language specifically identifies Bellcore and subjects it to the manufacturing prohibition, Bellcore should bear the burden in this petition of establishing that it is no longer owned or controlled by two or more RBOCs before it is relieved of the manufacturing restriction. A separate proceeding is necessary to give parties an opportunity to review the transaction and comprehend the nature of any continued financial relationship between the post-sale Bellcore and the BOCs. Only after the FCC conducts this proceeding and after Bellcore has demonstrated that it is no longer an affiliate of two or more BOCs or RBOCs should the FCC allow Bellcore to engage in manufacturing.

Respectfully Submitted,



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